Missouri Division of Finance

UPDATE

A Report of Missouri State Chartered Financial Institutions

Issue 04-2 July 2004

From . . .
Commissioner D. Eric McClure

I am once again proud to report that the citizens of Missouri are well served by a vibrant, safe and sound banking system. Missouri has the sixth highest number of banks in the country. This high number of community banks is an important contributing factor in Missouri's growing economy. These banks are focused on the success of their local communities and, on average, our banks lend out more per deposit than other banks nationwide. The positive economic impact and the supportive relationships our banks have with small and mid-sized businesses should not be underestimated. Groups continue to show interest in forming new banks and trust companies. The number of problem banks remains at a record low, capital levels are strong and asset quality is good. In brief, our projections are all favorable even though we will be closely watching rising interest rates and fuel prices.

Fraud, I regret to report, is alive and well. We have had several instances recently of large losses resulting from fraudulent activity, both internal and external. There have been enough cases that I believe there is indeed an unfavorable trend developing. We must all do what we can to fight this trend and maintain disciplined policies for fighting fraud on all fronts.

We plan to begin Bank Secrecy Act examination procedures during the next few months concurrently with our regular safety and soundness examinations. Most of our banks have already received several BSA examinations by the federal authorities. We are doing this in part, in the spirit of regulatory relief, so that the federal regulators will not be required to come in for a separate BSA examination during the state's exam cycle. We are working closely with both the Federal Reserve and the FDIC to make sure that our efforts will satisfy their requirements.

In This Issue:

Issues related to federal preemption of state laws by the Comptroller of the Currency as well as several large bank mergers are changing the landscape of our dual banking system very rapidly. Currently 47 of the largest 100 banks in the country are state charters. Several large banks have announced conversions and several other mergers are pending which may dramatically change this picture on the large bank scale. While I do not anticipate significant changes for our Missouri state chartered banks, we are closely monitoring these events as there must continue to be an effective dual banking system on the large bank level to ensure the long term viability of the dual banking system which we enjoy on our community banking level. The ability of a bank to choose its regulator has served our industry and country very well. I worry that this ability for large banks to choose the state charter may be lost as several of these conversions may in effect collapse some states' examination infrastructure in a very short period of time.

Please mark your calendars for our fall Outreach meetings around the state. This is our opportunity to meet with you and other bankers in your respective regions to discuss the many issues relating to our industry and those particular to your region.

Sikeston - October 13 St. Louis - October 14
Kansas City - October 19 Jefferson City - October 21
Springfield - October 27

INDEPENDENT DIRECTORS

When a bank begins experiencing problems and falls under the regulatory spotlight, one critical area regulators evaluate is the composition of the board of directors.

- *Is the board truly independent of executive officers?*
- *Can the board be objective and offer perspective in evaluating the actions and recommendations of the CEO?*
- *Does the board have the ability and willingness to challenge managing officers to make changes and hold them accountable?*

The breadth and depth of individual board members are major indicators of the answer to such questions. Boards comprised of family members, bank officers, or "good buddy" associates are missing a valuable resource – *independent* directors. While there is little doubt relatives, bank officers and close friends may have a keen interest in the institution, such individuals are not truly independent directors. They may be subject to the influence of the CEO and extremely hesitant to voice differences of opinion or force management reforms.

It is not unusual for regulators to insist (informally or through enforcement actions) on the addition of outside independent directors when circumstances warrant. Outside directors bring not only their independent judgment to the table, but also varying professional backgrounds, business skills, and familiarity with different segments of the community. Outside board members also provide opportunities for diversity in race, gender and age.

When pressed to recruit independent board members, a common response is that it is impossible to find a competent local director, or one that is willing to accept the potential liability. Admittedly there are challenges, but experience has shown it is possible to attract strong individuals who are proud to assist the bank – even troubled institutions. One way is to form a nominating committee of the board to target new director candidates. The committee then recommends candidates to the full board for nomination. To prevent undue CEO influence in the selection process, the CEO should not be a voting member of the nominating committee.

What is *an independent* director? Regulators commonly use standards such as:

- Not an officer or employee of the bank;
- Does not own more than five percent bank or holding company stock;
- Not related by blood, marriage, or common financial interest to an officer, director, or shareholder owning more than five percent of the bank or holding company stock; and
- Not significantly indebted to the bank.

The Council of Institutional Investors offers additional considerations:

- Has never been employed by the bank or an affiliate in an executive capacity;
- Has no personal service contracts with the bank;
- Not a paid advisor or consultant to the bank;
- Not paid by a significant customer or supplier of the bank; and
- Not a paid executive of a foundation or university that receives significant grants or endowments from the bank.

DIVISION OF FINANCE BANK SECRECY ACT (BSA) PROCEDURES

In an effort to relieve regulatory burden on state chartered institutions and assist Federal regulators, the Missouri Division of Finance will begin evaluating bank BSA procedures during regularly scheduled examinations. The Division's BSA examination will eliminate the need for a separate Federal BSA examination during the year for banks with a well-managed program.

The Division plans to start this program in September of this year. If there are questions regarding this, please feel free to contact the Division of Finance at 573-751-3242.

DIVISION OF FINANCE DIRECTOR ORIENTATION PROGRAM

The Division is in the process of developing a Director Orientation Program designed to assist new directors in learning the responsibilities of the board. The program will focus on state and federal regulations, risk management tools, and performance measurement techniques. The regulatory rating system will be explained and information technology controls and procedures will be discussed. The program will be offered on an as needed basis starting September 1, 2004 and will last approximately six hours. If you would like further information, contact Chief Examiner Dean McCracken at 573-751-4297.

LEGISLATIVE UPDATE

The 2004 session of the Missouri General Assembly enacted a number of provisions of interest to financial institutions. **These provisions, if approved and signed by the Governor, will take effect August 28, 2004.** The changes in the law will include:

Inter-bank brokered CDs - Senate Bill 1093

Private industry has developed a fee-based service for banks to broker savings deposits between banks, on behalf of their customers. This program will provide 100 percent federal deposit insurance coverage for aggregate deposits exceeding $100,000. Senate Bill 1093 makes this inter-bank deposit brokering service available for investment of public funds. Using this program will reduce the required amount of securities that must be pledged on public entity deposits, since a greater percentage of the deposit will be covered by federal deposit insurance. The local customer relationship is maintained because the total deposit is reported on one statement from the local bank while each deposit account is identified separately on the statement. The program provides for settlement adjustments between participating banks so each bank can customize their own deposit terms based upon their market strategy as it relates to savings accounts. This program also provides for a participating bank to receive reciprocal deposits from other banks, which assures that equivalent or offsetting funds are banked in the local community and helps avoid criticism that local deposits of public funds are being invested outside the area. Two new sections of law result from this change. Section 67.085 will authorize the program for Missouri governmental entities and Section 362.112 will allow banks and trust companies to offer the program provided that the deposits are federally insured.

"529" College Savings Plan – House Bill 959

This bill amended the state's "529" College Savings Program to authorize a deposit program option. During the next several months, the Missouri Higher Education Savings Program Board will be implementing the new option for the program.

CONSUMER RELATED – House Bill 959 and Senate Bill 1233

Section 365.020(5) was amended to eliminate the $7,500 limit to coverage under Chapter 365, the Motor Vehicle Time Sales Act. Rather, all motor vehicle time sales will be subject to the Act from and after the effective date of this change (August 28, 2005) and it should be noted that the notice of default and right to cure and all other provisions of Sections 408.551-408.562 will, likewise, apply to such time sales;

Section 365.080 of the Motor Vehicle Time Sales Act was amended to provide for the sale of service contracts and similar products on motor vehicle time sales contracts;

Section 365.100 of the Motor Vehicle Time Sales Act was amended to authorize the recovery of "all other reasonable expenses incurred in the origination, servicing, and collection of the amount due under the contract";

Section 408.032 was modified to increase the fee for expediting the issuance of a motor vehicle title from $6 to $15;

Section 408.140.1(4) was edited to eliminate an ambiguity regarding late charges wherein there appeared to be 2 minimum late charges available. It also enumerates expenses available upon repossession;

A new Section 408.178 provides for a deferral fee on "non-precomputed loans";

Section 408.190 was amended to clarify the scope of Sections 408.120-408.190 and Section 408.232 was similarly amended to explain the scope of the Second Deed of Trust Act;

A new Section 408.480 directs that changes to certain sections of the Consumer Loan Act, (a/k/a Small Loan Act) are remedial in nature and are to be construed accordingly;

A new Section 432.047 provides for a statute of fraud requirement on business loans, similar to that for consumer loans;

Section 443.130 will now allow a satisfied creditor more time to provide a deed of release (i.e. 45 days rather than 15 business days) and to change the penalty for violations (i.e. from 10 percent of the original principal, to the lesser of $300 per day after the 45th day up to a maximum of 10 percent of the original principal);

A new Section 427.225 creates a special cause of action regarding the deceptive use of a financial institution's name (e.g. stating or implying that an uninvolved financial institution is a participant in an advertised program).

Trust Law Revision - House Bill 1511

The details of House Bill 1511 are vastly beyond the scope of this article but we do note that the General Assembly repealed large parts of Chapter 456, the trust law, and replaced them with over 150 new sections, designated at Sections 456.1-101 - 456.11-1106 which has been entitled "The Missouri Uniform Trust Code".

PROTECTION OF CONFIDENTIAL BANK INFORMATION AND REGULATORY FILINGS

Information that the Missouri Division of Finance obtains from banks is protected from disclosure under Sections 361.070 and 361.080, RSMo. The Division strictly adheres to these requirements to assure that sensitive bank or customer information is not publicly disclosed. Where legal process or public duty compels production of sensitive information, the Division follows established internal procedures to assure that disclosure is only to law enforcement officials or that a court-issued protective order is in place to limit access and disclosure of sensitive information produced under subpoena to authorized attorneys and witnesses.

Sometimes private litigants attempt to obtain sensitive information directly from banks that may have been provided to state or bank regulatory officials. In most cases the information either cannot be disclosed or disclosure is limited. Banks are sensitive to privacy concerns and also to protecting their own competitively sensitive information. Banks are also concerned with potential liability if sensitive information is improperly disclosed.

Recently, all of the federal banking regulatory authorities and FinCen issued a joint advisory (FDIC-FIL 67-2004) to tell financial institutions about a recent federal court case, *Whitney Nat'l Bank v. Karam*, 306 F. Supp.2d 678 (S.D. Tex. 2004), that reaffirms laws protecting SARs from disclosure and protecting financial institutions and their employees from civil liability for filing a SAR or for making disclosures in a SAR. Congress provided these "safe harbor" provisions in 1992, when it passed the Annunzio-Wylie Anti-Money Laundering Act. This law is codified at 31 U.S.C. § 5318(g)(3).

In recent years, several courts have disagreed about the scope of the protection afforded by the safe harbor provisions. The federal district court in *Whitney* sided with the majority of courts that have interpreted the safe harbor provisions to afford unqualified protection to financial institutions and their employees from civil suit.

In the *Whitney* case, individuals filed a defamation suit against a national bank, claiming that the bank wrongfully accused them of illegal lending activity when it filed a SAR. In the suit, the individuals sought discovery of any oral or written communications the bank may have had with law enforcement concerning their suspected illegal conduct. The individuals did not seek a copy of the SAR because a clear provision of the Bank Secrecy Act prohibits such disclosure to the people who are reported in the SAR, so instead they sought information from the bank about any disclosures it may have made to law enforcement surrounding the possible filing of a SAR.

The *Whitney* court ruled that a bank may not produce documents in discovery evidencing:

- the existence or contents of a SAR;
- communications pertaining to the filing of a SAR or its contents;
- communications with government authorities that led to the filing of a SAR or in preparation for the filing of a SAR;
- communications that follow the filing of a SAR intending to explain or clarify the SAR; or
- the existence or content of oral communications to authorities regarding suspected or possible violations of laws or regulations that did not lead to the filing of a SAR.

The court noted, however, that the safe harbor protections do not apply to documents upon which a SAR was based that a bank may have generated or received in its ordinary course of business, unless producing these documents would confirm the existence of a SAR.

(Continued)

While the *Whitney* court ruled in a case involving a national bank and the rules and regulations of the Office of the Comptroller of the Currency, the five federal financial institutions supervisory agencies and FinCEN have taken the position that the court's rulings apply to all financial institutions that file SARs in accordance with suspicious activity reporting rules.

The federal agencies expressed confidence that financial institutions and their employees that follow the prescribed agency regulations and SAR filing instructions will be fully protected by the safe harbor provisions of the law. The agencies emphasized that all financial institutions covered by the agencies' SAR reporting rules should establish internal processes to handle the filing of SARs as well as requests for sensitive information from law enforcement authorities and from litigants in private lawsuits regarding suspicious activities and reporting to law enforcement.

Communicating with law enforcement and regulatory authorities through these processes, or in response to a subpoena from federal, state, or local law enforcement agencies or other forms of compulsory process, such as a request from FinCEN pursuant to section 314(a) of the USA PATRIOT Act, will provide maximum legal protection for financial institutions.

MISSOURI SAR ACTIVITY

The number of Suspicious Activity Reports (SAR) filed by Missouri financial institutions totaled 2,873 in 2003, up three percent from the prior year. Missouri ranks 22nd in the number of filings of all U.S. States and Territories, compared to California which ranks first with 68,546 filings.

Suspected Violation Type – Year 2003 Filings by Missouri Financial Institutions			
BSA/Structuring/ Money Laundering	35%	Debit Card Fraud	1%
Bribery/Gratuity	0%	Defalcation/Embezzlement	3%
Check Fraud	12%	False Statement	4%
Check Kiting	5%	Misuse of Position/Self Dealing	2%
Commercial Loan Fraud	2%	Mortgage Loan Fraud	6%
Computer Intrusions	0%	Mysterious Disappearance	2%
Consumer Loan Fraud	2%	Wire Transfer	1%
Counterfeit Check	7%	Terrorist Financing	0%
Counterfeit Debit/Credit Card	0%	Identify Theft	1%
Counterfeit Instrument (Other)	1%	Other	15%
Credit Card Fraud	1%		

Source: FinCEN. The SAR Activity Review – By the Numbers, Issue 2, May 2004. http://www.fincen.gov

LOWER STATE BANK ASSESSMENTS

Division of Finance Commissioner D. Eric McClure has announced that Missouri state-chartered banks will see a reduction in state assessment rates this year. The new average rate for fiscal year 2005 is $0.108 per thousand dollars in total bank assets, down from $0.116 for fiscal year 2004, a 6.9 percent decline. The combination of growth in state-chartered financial institution assets and little change in the net cost of the Division's operation allowed the reduced rate. The annual assessment rate has declined each year since 1998 when it was $0.199. Expenses of the Division of Finance are entirely reimbursed by regulated financial institutions and licensees - no general tax revenue is used.

BANKING PERFORMANCE

Missouri state-chartered banks have continued to prosper. As of March 31, 2004, 299 state chartered banks held $53.9 billion in assets and $43.5 billion in deposits. These totals represent growth rates of 7.5 and 6.0 percent, respectively, since March 31, 2003 when 299 banks held assets and deposits of $50.1 billion and $41.1 billion, respectively. During the preceding twelve months, four banks left the state banking system through merger or consolidation. Four new banks were chartered.

Selected performance measurements of Missouri state chartered banks include:

	Missouri State Banks			
	3/31/2004	3/31/2003	12/31/2003	12/31/2002
Yield on Earning Assets	5.29	5.76	5.47	5.93
Cost of Funding Earning Assets	1.44	1.88	1.66	2.23
Net Interest Margin	3.85	3.88	3.82	3.70
Loan Loss Provision to Average Assets	0.26	0.25	0.27	0.26
Return on Assets	1.11	1.16	1.13	1.09
Net Charge-offs to Loans	0.04	0.04	0.27	0.28
Non Performing Loans to Total Loans	1.77	2.36	1.76	2.03
Tangible Equity Capital to Assets	9.04	8.90	9.01	8.87
Loans to Assets	69.74	68.45	70.00	68.35
Earning Assets to Total Assets	92.48	92.02	91.94	92.06

Missouri state-chartered banks continue to be in good condition. Only eight banks failed to be profitable during the first quarter of 2004, including two recently chartered de novo institutions. Overall, earnings performance remains good and stable. The number of problem banks has declined and is low. Currently only five Missouri state-chartered banks are considered "problem banks" due to their composite CAMELS rating being a "3".

CALL REPORT MODERNIZATION INITIATIVE

Beginning with the third quarter 2004 filing period, a new, more efficient Internet-based system for submitting and processing Call Report data will be utilized. This project is a coordinated effort among the federal banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC). The initiative will result in faster delivery of accurate Call Report data. While largely transparent to them, the new process requires banks to complete all edit resolutions during Call Report preparation, which differs from the current practice in which some edits are resolved after data has been submitted. Banks will also need to use the Internet to submit data and receive notifications from the FFIEC agencies. Some institutions may need to begin the Call Report preparation process earlier to ensure timely submission of quarterly data.

Detailed information on the modernization project is available on the web at www.ffiec.gov/find.

COMMISSIONER McCLURE BECOMES CHAIRMAN-ELECT OF CSBS

On May 5, 2004, Commissioner D. Eric McClure was elected to the post of chairman-elect of the Conference of State Bank Supervisors (CSBS) at its annual meeting. He was chosen for this position by a group of his peers and will take office as chairman at the annual meeting to be held in June 2005. Department of Economic Development Director Kelvin Simmons commented "I extend my congratulations to Eric for being elected as the next chairman of the Conference of State Bank Supervisors. It is quite an honor to be selected by your peers to serve in such a leadership position. Eric has done a great job of maintaining high standards in the supervision of Missouri's banking system and I am sure he will provide outstanding leadership at the national level as well."